Rediscount Rates, Bank Rates and Business Activity

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THE problem of greatest interest and importance now confronting the Federal Reserve Banks, the commercial banks and the business world, is the rediscount rate and its effect on or relation to business activity.

The simple answer to the question whether the rediscount rate of the Reserve Banks should be higher or lower than the rate charged by commercial banks—whether this means the line-of-credit rate, over-the-counter rate or commercial paper rate is not clearly defined—is that the rediscount rate should be higher.

This answer seems to flow readily from British practice and recent American experience. But the economic situation, at home and abroad, is not so simple as to permit this offhand and categorical answer. American experience under the Reserve System has not been sufficient for the dogmatic statement of a formula for the future. The Reserve System has not functioned to any extent under conditions it was designed to meet; it has faced chiefly the very unusual conditions which attended the prosecution of war and the uncertainties and abnormalities that followed. At this time it seems impossible to do much more than state the problem as it is made out of and affected by a great variety of elements. The ascertainment of these elements involves investigation of business customs, bank habits, government operations and, perhaps, the psychological influence of public sentiment.

It is hardly possible to base any rule of future action in regard to rediscount rates on experience as gained by the Bank of England. Conditions in England and America are so different that the British rule as to the bank rate contains little of value except for suggestion, and even this little decreases as the banking and commercial paper customs of the two countries are contrasted. In the United States, for instance, the Reserve Banks have no direct relations with the public and receive deposits only from banks and the government. In this country the "open market" has few points in common with the English bill market. In the United States there are over 30,000 independent banks scattered through a vast territory whose activities are tremendously varied, instead of a few banks with thousands of branches serving a country of high industrial and commercial development.

The view is often expressed that the rediscount rate should be invariably higher than the market rate—usually meaning the prevailing rate for commercial paper—because the Reserve Banks are, after all, *reserve* banks and should be called on for rediscounts only when the bank desiring to borrow is under strain. There can be no disagreement about the desirability of the increase in rediscount rates when business expansion needs to be checked, and there may be reason for keeping them regularly higher than the market rate. It must not be forgotten that, whatever the Reserve Banks may be in law, in fact, they are regarded no less by bankers than by business men and the public as a kind of financial hospital to which all classes may go to have their wounds treated, regardless of the causes of the wounds. The banker, and the business man through his banker, wishes the same treatment whether he

has been hurt through his own derelictions or through a conjunction of economic causes, unforeseeable and uncontrollable. But the determination of a rediscount policy for the future calls for close analysis.

INFLUENCES THAT HAVE AFFECTED REDISCOUNT RATES

Since the depression following the War the factors influencing rediscount rates have been given serious consideration. At its meeting in September, 1921, the Federal Advisory Council expressed the view that rediscount rates should bear a direct relation to a Federal Reserve Bank's reserve and to the general money market, and that, in addition, consideration should be given to the items enumerated in the Council's recommendation of May 17, 1921, as follows:

1. The reserves of the Federal Reserve System as a whole.
2. The reserve position of the Federal Reserve Bank whose rate it is contemplated to change.
3. The condition of all the banks of the country as a whole, and of the several Federal Reserve districts.
4. The economic and financial condition of the country.
5. World conditions, both economic and political.
6. The eventual establishment of a credit rate policy for the Federal Reserve Banks by which the rediscount rate to member banks is higher than the prevailing commercial rate, taking due consideration of the prevailing open-market rates for various classes of loans both in this country and abroad.
7. Uniformity of rates, while at times practicable and desirable, should not be adopted as a fixed policy, the System being predicated upon the principle that varying conditions might exist in different sections of the country.

It was further suggested that with reference to the general money market the following factors should be considered in arriving at a conclusion as to what is the current rate for money:

1. Rates charged by banks to their general customers.
2. Rates for one-name paper bought through note brokers.
3. Open-market rates on bankers' acceptances.
4. Rates on Treasury certificates.

This series of rules is apparently given potentially. What have been the determining factors in fixing rediscount rates heretofore seem nowhere to have been given in a similar summation. In the first year or two of the Reserve Banks' operations little attention was given to the rediscount rate. Money was plentiful and there was little rediscounting. The War and its demands brought a change. It is no secret that government financing took precedence over everything else. The rediscount rate, regardless of any influence it might have on business, was adjusted so that the purchasers or holders of war bonds would receive preferential treatment. Otherwise, it is doubtful, with adherence to the Reserve Banks as the instruments whereby credit was to be made available for war purposes, if the war bonds could have been successfully sold at the rates they bore. It was when this need became apparent that the rate was placed at a low point. Business was, of course, a beneficiary. There was no departure from this policy during the War nor, as is often pointed out, until some time after the Armistice.

On pages 62 and 63 of the hearings entitled "Reviving the Activities of the War Finance Corporation," will be found the following by Governor Harding:

The Federal Reserve Board adopted a policy in order to assist in the war financing

which was economically unsound. I say this frankly. Congress authorized certain loans. It authorized the Secretary of the Treasury to determine the rates at which the loans should be issued. The Secretary of the Treasury asked the advice of experts and then fixed the rates of interest to be borne by the several issues of bonds, notes, and certificates. During the time we were actually at war, something like $18,000,000,000 of bonds were sold to the people, an amount certainly in excess of the normal investment power of the American people in such a short time, and the only way in which those loans could be financed was through the instrumentality of the banks. The only way the banks could undertake to do it was to get some assistance from the Federal Reserve Banks and at a low rate. The low rate of interest borne by these bonds was fixed with a view of holding down the expenses of the government as far as possible. Anyway, that is something the Federal Reserve Board has no responsibility for. In order to make possible the floating of these bonds we fixed a rate less than their coupon rate. Some member banks announced that for a period of six months there would be a rate of 4 ¼ per cent on notes secured by government obligations. The result was that there was no loss to subscribing banks pending the distribution of the bonds to the public. There were successive bond issues. The principal reason why discount rates were not increased earlier than they were in 1919 was on account of Treasury financing.

Thus it appears that government financing and the desire to have war bonds bear low rates of interest were the determining factors until disaster was scented in 1919. Then present and impending troubles dictated the increase of rates, which was belated. It was some time before this increase that liquidation began. It was a considerable time afterward that deflation became a visible reality. It may be said only with diffidence that the increased rates had anything more than a moral effect. Members of the Reserve Board said repeatedly, and cited figures to show, that the peak of credit and currency expansion was reached some months after higher rates were made effective. This indicates either that business had such an impetus that rediscount rates had no effect in stopping it, or, if they had any effect, considerable time was required to make it apparent. If this experience is to be taken as a demonstration of the efficiency of an increased rediscount rate to stay business activity, it must also be taken as a first indication of the time relation between an advance or change of rate and business operations.

But whether the high rediscount rate did or did not halt business and force deflation and liquidation, or whether business toppled over for other reasons, there is no doubt that it toppled. Gradually the credit situation cleared and is still clearing. Coincident therewith further study of the rediscount rate and its influence and effect began. As the reserve percentages of the Reserve Banks began to mount, the demand for lowering of the rates became more and more insistent. The increase of reserves was not, however, due entirely to liquidation. The flow of gold from abroad was steady, and became a very important, if not the most important, factor in building reserves up to a high point. It must also be noted that the rates charged by commercial banks did not go down either simultaneously with those of the Reserve Banks, or proportionately to them. Commercial banks were affected only indirectly by the great inflow of gold. It required liquidation by business to permit them to build up their reserves and pay off their debts to the Reserve Banks.

This would seem to show that rediscount rates were fixed with no consideration of the rates charged by the commercial banks. The assump-

tion of a causal relationship between the two, therefore, remains to be proved by the presentation of evidence that the experiences of the past two years does not offer.

THE TIME RELATIONSHIP BETWEEN BUSINESS COMMITMENTS AND BORROWING

If no relationship, or one that is indirect or nebulous, exists between rediscount rates and commercial bank rates, it becomes apparent that there can be no relationship, or, at least only a very remote one, between rediscount rates and business activity; it is the commercial bank rate that business pays, not the rediscount rate.

For present purposes, then, the question may be stripped down to the time relationship between the rediscount rate and the commercial bank rate, between the commercial bank rate and business activity, and then between the rediscount rate and the latter. For the present, also, it will be necessary to ignore the manifest influence of remote and indirect causes. In a business scheme so intricate as that of the world today, it would be hazardous to be dogmatic about such relationships. The problem is, however, to determine, if possible, the more immediate relationships—the causes which act and react on one another so as to permit the application of direct evidence. It is pertinent here to note, for instance, that there are some thousands of banks which are not members of the Reserve System; that each operating bank is an independent entity, subscribing to no rules as to interest charges and often getting "all the traffic will bear"; that loan risks vary with classes of business and in different districts, and that the demand for capital forces new and undeveloped sections to bid high in order to attract funds. It is probably only in the large centers and well developed industrial districts that money rates are subject to the controlling influence of reserve condition, supply and demand, gold imports, etc.

To get at the time relationship between business activity and borrowing, it is permissible to take for example the customary operations of a merchant or manufacturer. It is common knowledge that his interest in the present state of all business and of his own business is shared with his concern for what the future holds. He plans and manufactures and buys for a coming season. No matter how active present operations, the future concerns him as much. He may or may not sound out his banker as to his coming financial needs. Whether he does or not, he makes contracts and commitments for a coming season. If the banker has committed himself in such cases, he will to some extent have foreknowledge of the demand to be made upon him. But often, if not usually, he may be wholly unaware of what his customer contemplates. Business men will not arrange in advance for credit unless they foresee the impossibility of meeting their obligations out of current resources. If they have a line of credit, they will not indicate their intention to use it at a particular time or during a particular season unless it promises to be insufficient for their prospective needs. Nor will the member bank signify its intention to rediscount in the future.

In such circumstances the business world, each unit operating by itself, may be building the foundation of a credit structure in the autumn; the commercial banks may not be called on for loans until spring and it may be midsummer before the contracts and commitments made months before are reflected by a demand for rediscounts at the Federal Reserve Banks. How

is a rediscount rate going to meet an over-extended condition, in the summer, which was produced by operations begun and completed many months before?

Commercial bank officials and those of Reserve Banks, also, study business conditions constantly. Many of them have information and statistical organizations. They gather the best statistical evidence they can, but the Reserve Bank officers have no privity of interest and no intimacy of relationship with business men. Even with superior advantages in this respect, officers of member banks cannot anticipate conditions except in a very general way. One banker might be alarmed at the prospect of a large demand for loans and his competing neighbor have no evidence of such impending events at all.

It is such conditions that call into play the highest banking skill and judgment. Such conditions demand of the banker a prescience which can come only from such a familiarity with business that he feels rather than knows what is before him. In making his half-intuitional estimates he will, of course, take account of the fact that the Reserve Bank is ready at hand if there is need. He will take care of his customers and try to adjust his rates to competitive conditions. His conclusive "no" will send potential borrowers to other banks, to the levelling of the business of all of them and a fairly accurate adjustment of interest rates. But, dealing only with banks, Federal Reserve officials will have an imperfect knowledge of these conditions. And yet upon them rests the obligation of leadership in checking or stimulating business by a proper adjustment of the rediscount rate, if the rediscount rate can do it.

It seems fair to say that while an effort may have been made or is being made to adjust rediscount rates on the basis of ascertained future business operations, the probability is that the rate has been fixed only in relation to what is or what has been, so far as it has been fixed at all in relation to business activity.

CONCLUSIONS

The import of this article has been:

1. That rediscount rates cannot be fixed on the basis of British experience.

2. The opinion that rediscount rates should be higher than commercial bank rates is based on experience during war conditions and business contraction which may not be a sufficient guide for the future.

3. Rediscount rates have heretofore been fixed chiefly by consideration of factors other than their possible effect on business activity.

4. Rediscount rates can affect business activity only through bank rates which bank customers must pay.

5. Bank rates are not only different in different sections, but are determined by present conditions, whereas business commitments are made for the future.

6. To influence business activity, bank rates would have to be determined in relation to the future commitments of customers and the rediscount rate would have to be in correspondence with the bank rate, both as to amount and time.

7. It is the knowledge and judgment of bank officers and reserve officers on which reliance must be placed for the control of business conditions through credit.

8. Insofar as the rediscount rate can affect business activity, it must be determined far in advance if it is to have any appreciable effect.

There has been no disagreement among bankers as to the necessity for raising the rediscount rate when the need of checking business activity was certain. If recent conditions gave promise of permanency, there could be no question as to the desirability of having rediscount rates always higher than bank rates. On the basis of

actual recent experience only one policy has been warranted. But as to a policy to control in the future, further experience must be the guide. In any event, changes in rediscount rates must be made well in advance of foreseeable changes in business activity, if the rates are to be used for the purpose they are commonly supposed to serve.

Theoretical Considerations Bearing on the Control of Bank Credit Under the Operation of the Federal Reserve System

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THE most important change in our banking machinery entailed by the Federal Reserve Act as bearing upon the question of the expansion and contraction of our circulating media is the introduction of compulsory bankers' banking. The essence of bankers' banking in the United States is the reserve dependence of the commercial banks upon the regional institutions. The deposits on the books of the regional banks are the reserves of the commercial banks. Inasmuch as the deposits of the regional banks are themselves expansible and contractile, the deposits of member banks, which would be elastic even if their reserve foundation were *in*elastic, now have an elasticity raised to the second power.

Moreover, the elasticity of both the deposits of the regional banks and of the members are buttressed and supported by the Federal Reserve note-issue provisions. Under the old national banking system an expansion of loans and a consequent expansion of deposits in the banking system was ordinarily accompanied by a rising physical volume of trade and rising prices. The growth in business transactions, coupled with higher prices, impelled men to carry more money in their pockets and merchants more money in their tills. But the swelling of pocket and till money involved a withdrawal of cash from the commercial banks. As money left the banks, their lending power was curtailed, and expansion of credits and rising prices were brought to a halt.

Under the operation of the Federal Reserve Act an expansion of loans and a consequent expansion of deposits, accompanied by rising prices and expanding physical volume of trade, also impel men to carry more "money" in their pockets and merchants, more in their tills. Since 1914, however, the demand for additional pocket and till money has been met by the issue of *promises* of the Federal Reserve Banks to pay money. Lawful money is no longer lost by commercial banks. Instead it is held by the Federal Reserve Banks as a foundation on which is reared a three-fold credit structure: (1) deposits of Federal Reserve Banks; (2) deposits of member banks and (3) Federal Reserve notes.

The control of credit under our Federal Reserve System, therefore, becomes a matter of greater importance than under the old régime. Formerly an automatic check was imposed on credit expansion before extreme limits were reached. Today, in the absence of that automatic check,